

ignored by current network capability, which is not only more distance-insensitive, but boundary-insensitive.

To be sure, there could be a simplification of today's procedures with these options, and the carriers could experience substantial cost savings. However, absent extension to all accounts and a widening of the ranges, neither option will achieve all it could.

**C. Responses to Specific Questions on the Depreciation Rate Range and Basic Factors Range Options.**

The Commission raises a number of questions about the manner in which the range options would be implemented.<sup>32</sup> The answers to these questions, set out below, generally apply equally to the Depreciation Rate Range option and the Basic Factors Range option.

USTA has already articulated responses to some of these question, i.e., one set of ranges should apply to the entire industry, and all plant accounts should be included. The Commission asks about the timing and mandate of implementation. USTA believes that a uniform commencement date of 1994 can be used, but that carriers should have at least three years to move accounts into any industry-wide ranges that are set.

None of these issues should present an obstacle to implementation. The Commission should establish each industry range using estimates provided by the affected carriers. Updates of the ranges would be undertaken periodically, with input from carriers. Benchmark studies of other companies and industries, individual company

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<sup>32</sup>NPRM at ¶¶ 28-29.

plans and Commission filings, and technology assessments also should be used. USTA believes that updates on minor accounts should be undertaken no less often than every five years. Technology-driven and major accounts should be updated more frequently - every three years appears to best balance the need with the burden.

Equal life group (ELG) should continue to be used, initially and also in updates.<sup>33</sup> The data is no longer sensitive. On average, carriers are currently depreciating more than 60% of their plant using ELG. USTA data already supplied to the staff show that ELG rates are not materially impacted by using industry curves.

**V. THE DEPRECIATION SCHEDULE OPTION SHOULD BE REJECTED BECAUSE IT IS NOT ACCURATE AND DOES NOT ACHIEVE THE COMMISSION'S SIMPLIFICATION OBJECTIVES.**

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USTA has expressed strong support for the Price Cap Carrier option for fully subject carriers, and also has supported the Depreciation Rate Range option as a second best alternative. There is one option that USTA rejects at this point, the Depreciation Schedule option. This option would establish a schedule of rates, using Commission-defined averages.<sup>34</sup> While the paragraph that describes this option, suggests it would achieve simplification, USTA concludes that this option, as defined in the NPRM, would appear to be the least likely to achieve greater simplification or greater accuracy in depreciation.

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<sup>33</sup>See NPRM at ¶ 25.

<sup>34</sup>NPRM at ¶¶ 33-34.

This option would appear to require tracking of accruals by vintage,<sup>35</sup> a practice that is labor-intensive for carriers and that would significantly increase accounting work. The Commission has previously initiated procedures using vintage reserves and rates, it then rejected these procedures after only a short time.<sup>36</sup>

The Commission already recognizes that this option also has the defect of deviating most significantly from actual depreciation requirements.<sup>37</sup> The results would not be tied to the actual plans or market demands of any individual carrier, but would rely on conceptual averages. On its face, this option also appears to utilize an arbitrary selection of plant groupings. The Depreciation Schedule option would not achieve the beneficial results that the Commission hopes for, and it would fall far short of the optimum balance of simplification, accuracy, competitive responsiveness and network advancement.

**VI. FORWARD-LOOKING, SIMPLIFIED DEPRECIATION POLICIES CAN INCORPORATE INHERENT AND SELF-CORRECTING SAFEGUARDS THAT ASSURE THE PUBLIC WILL NOT BE ADVERSELY AFFECTED.**

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A primary concern expressed by the Commission in the NPRM relates to the manner in which the public can be served by greater flexibility, and how it can protect against possible abuse.<sup>38</sup> This concern can be addressed and resolved fully with

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<sup>35</sup>NPRM at ¶ 36.

<sup>36</sup>See, e.g., Order, Prescription of Revised Percentages of Depreciation, FCC 90-44, released January 31, 1990 at ¶ 23, ("Commission recognized that its requirement of vintage depreciation rates would soon become an overwhelming administrative burden.")

<sup>37</sup>NPRM at ¶ 33.

<sup>38</sup>See NPRM at ¶ 8.

simplified depreciation procedures. The Commission and the process of capital recovery itself each exert significant control now over the manner in which carriers must deal with depreciation. That will not change under the Price Cap Carrier option, or either of the range options. These controls can combine to provide effective ways to monitor the carrier's use of additional simplification and flexibility under any of the four alternatives.

**Capital Recovery and Accounting Processes.** The process of capital recovery requires that depreciation rates not allow an investment to be overrecovered. The investment value put in is all that can be depreciated. Commission rules and orders don't allow overrecovery.<sup>39</sup> Use of remaining life depreciation, as proposed for the Price Cap Carrier option, is designed to operate as a self-correcting mechanism.<sup>40</sup> Part 32 of the Commission's rules provides yet additional protection, assuring proper handling of depreciation. A related effective safeguard is the presence of GAAP accounting. GAAP accounting works from a base that is accepted across most industries, and it promotes sound accounting and depreciation practices. In addition, depreciation analysts track depreciation experience in this and in other industries, regulated and unregulated, to assess consistency.

**Market Pressures.** Carriers themselves have strong incentives to depreciate properly. Today's communications environment is extremely dynamic. Timely capital

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<sup>39</sup>See 47 CFR § 32.2(e) and 32.2000(g) (instructions for plant accounts and depreciation accounting are part of an accounting system that "will provide a stable and consistent foundation for the recording of financial data.")

<sup>40</sup>Amendment of Part 31, supra, 83 FCC 2d 267 (1980), recon. 87 FCC 2d 916 (1981).

recovery, based on appropriate depreciation rates, helps to generate funds for new and additional investment. A key challenge for carriers is to anticipate which technological direction that investment should take. Carriers are careful in assessing hardware and software investment needs. Competition, even the imminence of competition, is an effective disciplinarian.

An example of the dilemma faced by the carriers is instructive. A new and strategically important investment may have a useful life of 5 years. While an unregulated communications company may depreciate the same investment in that 5 years, a regulatory agency may set the life for ratemaking purposes for a carrier at 15 years, instead of 5 years. At the end of the 5 year life of the asset, the nonregulated company has had the opportunity to be made whole. Because of regulation, however, the carrier possesses an asset that is also at the end of its useful life, but that is only one-third depreciated. Another 10 years would be needed for the carrier to recover its investment. A prudent carrier knows it must reinvest. However, when a new asset replaces an asset that has not been fully depreciated, that new asset bears a double depreciation burden - its own and the unrecovered investment in the asset that preceded it. Over time, this is highly prejudicial to the carrier. The incentives within regulation to hold down current expense puts an extra burden on future customers - in both depreciation and in limiting carrier opportunity to adopt new technology.<sup>41</sup>

The carriers have shown that they are eager to move forward. Recently, most of the largest fully subject exchange carriers have identified major investment programs

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<sup>41</sup>See note 10.

related to their basic networks. Some recent cases are instructive. In late 1992, Bell Atlantic announced a major infrastructure improvement program that would upgrade its network in New Jersey at a cost of about \$1 billion. US West announced on February 4 a multi-year, multi-billion dollar investment program. Pacific Bell told the Commission on February 16 that it was spending over \$1 billion by 1997 to accelerate digital switch deployment.<sup>42</sup> BellSouth announced on February 17 that it will invest about \$9 billion over three years to improve its networks. And GTE announced a \$461 million network upgrade, in California alone, on February 18. These are only illustrations of how exchange carriers are responding by necessity to market pressures.

Certainly, these choices do not reflect abuse of capital recovery expectations or diversion of revenues. The opposite is true. They are a confirmation that the carriers' recognize their future investment needs, and are willing to take risks like any business to meet those needs. They must hope that the Commission will allow them the same opportunity to depreciate their investments that their competitors have.

Proper incentives to depreciate will foster prudent and measured investment. The actions of the companies identified above produce solid evidence that the subject carriers have not foregone prudent investment decisions.<sup>43</sup> Indeed, the Commission

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<sup>42</sup>See ex parte letter from Celia Nogales to Donna Searcy, February 16, 1993, for inclusion in CC Docket No. 91-346, Intelligent Networks.

<sup>43</sup>This is the basis upon which the Commission adopted its price cap orders for the exchange carriers. See Policies and Rules Concerning Rates for Dominant Carriers, LEC Price Cap Order, 5 FCC Rcd 6786 (1990), Order on Reconsideration, 6 FCC Rcd 2637 (1991) (Price Cap Reconsideration Order): "Opportunities presented by incentive regulation for enhancing efficiency in the LEC industry include the opportunity to provide better incentives for innovation." LEC Price Cap Order, 5 FCC Rcd at 6790, ¶

should encourage that investment with capital recovery changes to promote greater network use.

In contrast, slowed investment recovery will cause earnings to be overstated. Earnings for price cap carriers in this situation will rapidly become subject to sharing, and rate of return carriers potentially will be subject to overearnings complaints and rate reduction orders. More significantly for the business, such action will put carriers at risk for large future losses due to assets that will have been inadequately depreciated.

The future of the carrier's enterprise will become subject to unnecessary risk in either case. The carrier would not be balancing the use of its resources to promote optimum investment opportunity over time, and its failure to pursue a careful balancing would expose it to inevitable adverse competitive impacts, either now or in the future. Competitive unregulated companies tend to be consistent in their depreciation practices; they do not adopt practices that fluctuate or that could put their operations at risk. A carrier that signals to the market that its depreciation will fluctuate also will suggest to analysts that the carrier's results are at risk. This alone can affect its cost of capital. Carriers will continue to have strong pressures to remain careful and consistent under simplified depreciation rules.

**Commission Authority and Current Data Collection.** The Commission has many ways to monitor depreciation practices and to correct for any it finds to be adverse to the public interest. Its staff maintains a continuing oversight over depreciation reserves, through the ARMIS process and in the Form M reports. In a recent order on the 1993

Tariff Review Plans, the Common Carrier Bureau has required the annual submission by rate of return carriers of Schedule DEP-1, a detailed six-page schedule of depreciation information. That Schedule must be filed each year, whether or not that carrier will have a triennial depreciation proceeding in that year.<sup>44</sup> Similar information is collected during the year from the price cap carriers.<sup>45</sup> Any material changes in depreciation reserves or other capital recovery-related activities or facts will be obvious to the Commission staff from these data. The Commission will continue to be fully informed as to the assumptions and methods used by carriers.

**Price Cap Framework.** Additional safeguards are increasingly evident in the regulatory process itself. Price cap regulation and close scrutiny of the annual tariff filings of both price cap and rate of return carriers act to weed out unnecessary costs. Price cap carriers continue to have exactly the incentives to reinvest in increasingly efficient networks that the Commission anticipated when it implemented price cap regulation.<sup>46</sup> Their practices have been responsible and successful. For example, the

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<sup>44</sup>See Order, Cost Support Material Required for Annual Access Tariff Filings of Exchange Carriers, DA 93-192, released February 18, 1993, at ¶ 41 and B.1.

<sup>45</sup>For example, the carriers currently file quarterly financial and operating information on Form 43-01, annual USOA information on Form 43-02, financial and statistical data on Annual Report Form M, copies of their Form 10K annual report, infrastructure spending reports on Form 43-07 and operating data on Form 43-08. In addition, Commission staff collect other data.

<sup>46</sup>"These companies have given the public the best telephone service in the world." Statement of Commissioner Ervin S. Duggan, accompanying Price Cap Reconsideration Order, 6 FCC Rcd 2637, at 2743.



service outage reporting of carriers shows that network reliability actually is increasing, and is at more than 99.999% integrity now.<sup>47</sup>

**Competitor Interest.** The Commission has a growing number of "helpers" in identifying depreciation concerns. Competitors of the carriers have their own investment strategies, are familiar with the depreciation experiences of other fully subject carriers, and will be quick to identify perceived abuses by fully subject carriers to regulators. The very presence of these competitors can provide depreciation benchmarks for the Commission, particularly in areas where competition and technology are forcing the greatest change.<sup>48</sup> Other regulated carriers have already pointed out to the Commission the difficulties inherent in regulatory depreciation rate prescription when the environment is undergoing rapid change.<sup>49</sup>

**Absence of Carrier Control.** The strongest safeguard, however, is that depreciation manipulation simply can't work for a carrier. Changes in depreciation are treated as endogenous events under price caps.<sup>50</sup> Carriers are unable to "plan" for

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<sup>47</sup>Minutes of the April 29, 1992 meeting of the Network Reliability Council at ¶ 15; Minutes of the December 15, 1992 meeting of the Network Reliability Council at ¶ 19 (exchange carrier switches averaged 75 seconds of unscheduled down time or less per quarter, even including external causes.)

<sup>48</sup>The depreciation rates utilized by cable operators and interexchange carriers are well in excess of those used by subject exchange carriers. As a group, for example, cable operators use an (FR) rate of 13.9, in comparison with a 1991 exchange carrier (FR) composite of 7.0 - about half. AT&T's regulatory (MR) depreciation rate is at 13.8, and its remaining lives for metallic facilities range from 0 to 4.4 years. The cellular industry and other cable industry experience is referenced at note 9.

<sup>49</sup>See AT&T Petition for Waiver, supra, note 4.

<sup>50</sup>Price Cap Reconsideration Order, 6 FCC Rcd 2637, 2672 (1991) at ¶ 74.

particular earnings or sharing levels. The steps are far too fine. The earnings reports of subject carriers make that abundantly clear. Since earnings reports were first filed, earnings have become increasingly volatile.<sup>51</sup>

**Commission Ancillary Powers.** Finally, the Commission has significant ancillary powers. It has the authority to request additional information from a carrier when it has concerns about that carrier's depreciation practices, and it retains continuing authority to require depreciation auditing and reports by the carrier, and to audit a carrier's practices itself.

These powers combine to give the Commission wide room to adopt depreciation simplification here. Simplification will afford carriers the opportunity to reduce their administrative costs, and will provide them the limited additional capital recovery discretion that they need to help respond to the demands of competition and technology. At the same time, there are multiple levels of safeguards in place to assure that no ratepayer interests will be compromised.

## **VII. THE COMMISSION'S SIMPLIFICATION PROPOSALS ARE CONSISTENT WITH THE COMMUNICATIONS ACT.**

The NPRM asks whether the Price Cap Carrier option it sets out is within the Commission's power under the Communications Act.<sup>52</sup> USTA believes that the

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<sup>51</sup>A review of carrier Form 492 filings shows ever-increasing volatility in the carriers' earned rates of return.

<sup>52</sup>NPRM at ¶ 42. See also Concurring Statement of Commissioner Duggan, inquiring as to the impact of § 220(b) of the Act on the Commission's duties to prescribe percentages of depreciation that will apply to carriers' property. That concern was addressed in the preceding sections and is also addressed below. See section III.A.,

Commission has the authority to adopt depreciation rate prescription simplification using any of the four options set out in the NPRM. USTA also believes that the Act gives the Commission discretion to determine the level of scrutiny that depreciation rates merit, under any of the options. The Commission has the authority under the Act to consider the impact of various market or other factors that exert control over depreciation decisions, and can target its own review accordingly.

The Price Cap Carrier option anticipates that the Commission will continue to prescribe rates. However, it would do so within a process where the Commission would afford the first line of control to the marketplace itself. Carriers under price cap regulation already have severely limited incentives to increase depreciation rates for any reason other than network quality and effectiveness in serving customers. They cannot make new investments to raise their aggregate authorized level of earnings, since new investments cannot affect price levels.

The Commission's stated concern about the lawfulness of the Price Cap Carrier option relates to its conformance with section 220(i) of the Act. Section 220(i) requires that the Commission notify the affected state commissions, afford each such state commission an opportunity to present its views, and take such views into consideration.<sup>53</sup>

The requirements of § 220(i) can be accommodated fully in the notice and comment process anticipated by the NPRM. The Act does not require that there be a

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supra.

<sup>53</sup>NPRM at ¶ 42.

three-way meeting process, that affected state commissions participate in face-to-face meetings, or that oral presentation of views is necessary. Even today, for some carriers, the Commission accepts that triennial represetation meetings need not be held; there has been no adverse public interest impact when no such meeting occurs. USTA members certainly do not object to the participation of state commissions in the setting of interstate depreciation rates.<sup>54</sup> The process set out for the Price Cap Carrier option permits this; it only changes the nature of the "opportunity to each state commission to present its views" that is required by the Act.

If the Commission retains any concern that a state commission might not have adequate notice, the Commission could further reinforce state commission notice by providing in any rule or order adopted here that a fully subject carrier will provide copies of its depreciation filing, and any subsequent Commission-released Public Notice related to that filing, to the affected state commissions. The fact that an affected state commission is presenting its views will continue to carry an appropriately influential weight in the comment process.

Commissioner Duggan's Concurring Statement expresses a different misgiving about the Price Cap Carrier option. His concern appears to be related to the inability of the Commission or the commenting public to have enough information about a carrier's requested depreciation rates to comment. As the Commission has seen above, USTA does not view the Price Cap Carrier option as one which removes from the Commission

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<sup>54</sup>USTA itself has taken steps to facilitate state participation in such meetings and to help make those meetings more cost effective.

(or the public) either necessary data or Commission discretion to set rates under § 220(b).

The Act requires that the Commission:

"prescribe for (fully subject) carriers the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose..."

In discussing the Price Cap Carrier option above, USTA sets out the nature of the data that it expects would be submitted to the Commission, and that would be available to commenters. The Commission would remain well-informed about the carriers' accounts.<sup>55</sup>

Therefore, there is no legal impediment to the adoption by the Commission of the procedural change contained in the Price Cap Carrier option, nor is there a bar to the use of any of the other three options.

#### **VIII. SALVAGE TREATMENT SHOULD NOT BE CHANGED AT THIS TIME.**

The Commission has proposed an alternative for the handling of salvage.<sup>56</sup> Under this alternative, the Commission suggests that salvage would be removed from the depreciation process, and that carriers would be required to book the cost of removal and salvage as current period charges and credits. The Commission also asks whether this treatment is consistent with GAAP.<sup>57</sup>

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<sup>55</sup>The Commission would continue to obtain separately other reports related to a carrier's depreciation and its effect on tariffed rates.

<sup>56</sup>NPRM at ¶ 43.

<sup>57</sup>Id.

USTA opposes such a change if it is made mandatory for all carriers. Such a change could affect the timing of carrier accruals, and could have ratemaking, administrative and budget implications for some carriers. The present treatment of salvage accords with GAAP and would not be burdensome if it is retained under the Price Cap Carrier option or one of the other options.

#### **IX. CONCLUSION.**

The Commission's price cap orders took strong, positive steps to promote innovation and to attempt to have regulation work in concert with competitive forces rather than against them. However, there are other steps that are needed to achieve the benefits of incentive regulation more fully. One is available here - the Price Cap Carrier option.

In its LEC Price Cap Order, the Commission said of its rate base, rate of return system of regulation:

"We are also concerned that, particularly for the largest LECs, the system of regulation we currently employ does not serve to sharpen the competitiveness of this important segment of the industry at a time when markets for telecommunications goods and services are becoming increasingly competitive, both nationally and internationally."<sup>58</sup>

That sentiment applies to depreciation just as it applies to tariff pricing. USTA encourages the Commission to harness for depreciation regulation today


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<sup>58</sup>LEC Price Cap Order, 5 FCC Rcd 6786, 6790 (1990).

the same market incentives and pressures that are at work in the price cap ratemaking area.

Respectfully submitted,

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